Nos. 22174 and 22174-A

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES A. and AUDREY J. WARNER,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

JERRIE D. and LETA J. SCHOOLEY,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 51-60) is reported at 48 T.C. 49.

JURISDICTION

This petition for review (R. 63-66) involves federal income taxes for the calendar year 1963. On August 10, 1965, the Commissioner of

Internal Revenue mailed to taxpayers James A. and Audrey J. Warner a notice of deficiency, asserting deficiencies in income tax in the amount of $2,312.27 for 1963. (R. 6-8.) On the same date the Commissioner also mailed to taxpayers Jerrie D. and Leta J. Schooley a notice of deficiency, asserting deficiencies in income tax in the amount of $1,140.46 for 1963. (R. 18-20.) Within ninety days thereafter, or on September 28, 1965, James A. and Audrey J. Warner filed a petition with the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 1-8.) Also within ninety days thereafter, or on October 1, 1965, Jerrie D. and Leta J. Schooley filed a petition with the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of the 1954 Code. (R. 12-20.) The decisions of the Tax Court were entered May 2, 1967. (R. 61, 62.) The cases are brought to this Court by a petition for review filed July 31, 1967 (R. 63-66), within the three-month period prescribed by Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion that a corporation (Ranchers, Inc.) of which taxpayers were stockholders did not issue its stock in the manner prescribed by Section 1244 of the Internal Revenue Code of 1954, and that therefore taxpayers were not entitled to an ordinary loss deduction under that section for the year 1963.

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations are set forth in the Appendix, infra.

STATEMENT

The facts as stipulated (R. 25-44) and as found by the Tax Court (R. 52-57) may be summarized as follows:

Taxpayers James A. Warner and Audrey J. Warner timely filed a federal joint income tax return for the calendar year 1963 with the District Director of Internal Revenue, Boise, Idaho. (R. 52.)

Taxpayers 1/ Jerrie D. Schooley and Leta J. Schooley timely filed a federal joint income tax return for the calendar year 1963 with the District Director of Internal Revenue, Boise, Idaho. (R. 53.)

Sewmor Sewing Center, Inc. (hereinafter referred to as Sewmor), an Idaho corporation wholly owned by James Warner, is engaged in the sewing machine and vacuum cleaner sales business in Boise, Idaho. Sewmor had an excellent group of steady employees, averaging about ten in number. Sewmor had not advertised for employees for a period of over six years although the industry experienced a substantial turnover in employees. James Warner and Jerrie Schooley were employees of Sewmor. (R. 53.)

Ranchers, Inc. (hereinafter referred to as Ranchers), was a new domestic corporation organized under the laws of the State of Idaho with its principal place of business in Boise, Idaho. Its charter was issued on December 29, 1961. At the first meeting of the board

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1/ The term "taxpayers" will collectively refer to James and Audrey Warner and Jerrie and Leta Schooley.

of directors of Ranchers, held on January 5, 1962, James Warner was elected president, Joanne Warner was elected vice president, and Howard M. Deeds was elected secretary-treasurer. (R. 53.)

Ranchers' authorized capital was $100,000, divided into 10,000 shares of common stock at $10 per share. There was only one issue of stock, which was common stock. At the time of incorporation there were three qualifying shares of stock issued. (R. 53-54.) Ranchers qualified at that time as a small business corporation as defined by Section 1244(c)(2), 1954 Code, insofar as the provisions of that paragraph defining the size and capitalization of a small business corporation are concerned. (R. 27.)

The purpose of incorporating Ranchers was to create an incentive for the employees to stay with Sewmor, an incentive to work harder, and also to give them a chance to save money and build up some assets for themselves. This objective was to be accomplished by having Sewmor's employees invest seven percent of their salaries and commissions in a fund to be matched by Sewmor. The fund proceeds were to be used to purchase stock in Ranchers. (R. 54.) At Ranchers' first board meeting held on January 5, 1962, the following resolution was unanimously adopted (R. 32, 33, 54):

> BE IT RESOLVED that 3,000 shares of stock of Ranchers, Inc., be, and the same is hereby, set aside and allowed for purchase by the trustees of the employees of Sewmor Sewing Center, Inc., pursuant to the trust agreement attached to these minutes, and that the corporation from said 3,000 shares sell stock of the corporation to the trustees at its book value but not less than the par value, to wit, $10.00 per share; that upon receipt from the trustees of payment for said stock the same shall be issued to the trustees.

The trust agreement between Sewmor and its employees, alluded to in the resolution set out above, provided that if each employee agreed to have seven percent withheld from his gross salary, Sewmor would contribute a like amount to the trust fund for the benefit of that employee. The trustees would use the funds as available to purchase stock in Ranchers. The trustees would subsequently transfer the stock to the employees. The 3,000 shares allotted were available for purchase only by the employees of Sewmor. (R. 54-55.) Section (f) of the trust agreement provided as follows (R. 55):

> (f) When said allotted stock of Ranchers, Inc. to the amount of 3,000 shares has been purchased by Trustees or on the _____ day of _____, 196__, whichever occurs earlier, this trust shall be terminated and all unused funds of each Second Party [employees of Sewmor] as shown by the account sheet of said Second Party shall be refunded to the Second Party entitled thereto and upon presentation of the trust and voting trust certificate of said Second Party to the Trustee, the stock represented by said trust and voting trust certificate shall thereupon be issued and delivered to said Second Party. * * *

In addition to the resolution setting aside stock for Sewmor's employees, Ranchers' president, at the board meeting on January 5, 1962, stated that Sewmor wished to purchase additional stock of Ranchers and requested the board to adopt the following resolution (R. 34):

> BE IT RESOLVED that Sewmor Sewing Center be permitted to buy _____ shares of stock of Ranchers, Inc., at its book value but not less than its par value, to wit, $10.00 per share. That upon payment in cash therefor the stock be issued to Sewmor Sewing Center.

The resolution was unanimously adopted. (R. 34.)

At the time of the adoption of the resolutions the directors of Ranchers were considering using the proceeds from the sale of Ranchers

stock to Sewmor's employees to purchase commercial paper, to wit, sewing machine contracts. This plan, however, never materialized. (R. 55.)

At the annual meeting of Ranchers' stockholders on February 15, 1963, it was decided to discontinue the plan to use the trustees and trust certificates. Issuance of the stock would be made directly to each stockholder. It was also resolved to allow the employees of Sewmor to purchase additional stock from the allotted 3,000 shares alluded to above. (R. 55.)

At a meeting of Ranchers' stockholders and directors on February 18, 1963, it was decided to enter into a fire retardant program. They also decided (1) to purchase and did purchase a Northrup P-61 B airplane and (2) to employ Robert E. Savaria as a pilot and issue 100 shares of Ranchers stock to him for his services performed in equipping the aircraft for fire fighting purposes. (R. 55-56.)

During the months of February, March, and April, 1963, James and Audrey Warner subscribed to and paid for 1,541 shares of common stock of Ranchers at a cost of $15,410. Certificate No. 9, representing such shares, was issued to James Warner on September 30, 1963. The stock was paid for solely in cash. The stock was continuously owned by him until Ranchers was liquidated. (R. 56.)

During the months of February through July, 1963, Jerrie and Leta Schooley subscribed to and paid for 751 shares of Ranchers common stock at a cost of $7,510. Certificate No. 6, representing such shares, was issued to Jerrie Schooley on September 30, 1963.

The stock was paid for solely in cash and was continuously owned by him until Ranchers was liquidated. (R. 56.)

On August 29, 1963, Ranchers' airplane was wrecked and Robert E. Savaria was killed. No insurance was carried on the plane, and the loss sustained made it impractical to continue on with the business. (R. 57.)

At a corporate meeting held on November 21, 1963, the following resolution was unanimously approved (R. 57):

> BE IT RESOLVED, that Ranchers, Inc., abandon its corporate authority and forfeit its charter and dissolve, and that James A. Warner, the President, and Howard M. Deeds, the Secretary, are authorized to immediately pay all debts of the corporation, and that they be authorized and empowered to take any and all action, and to do any and all acts and things which may, in the judgment of the said officers, be necessary or proper to wind up the affairs of said corporation, and to distribute the assets, which consist chiefly of cash and accounts receivable, pro rata according to the respective interests of each shareholder.

In determining their taxable income for the calendar year 1963 on their federal joint income tax return, James and Audrey Warner deducted $13,161.97, and Jerrie and Leta Schooley deducted $6,414.52, claiming that the amounts deducted constituted a "small business stock" loss under Section 1244. (R. 57.)

In separate notices of deficiency sent to each set of taxpayers herein, the Commissioner asserted that the losses sustained by taxpayers in 1963 from the liquidation of Ranchers constituted a capital loss which cannot be treated as a loss from the sale or exchange of property other than a capital asset under the provisions of Section 1244 or any other section of the Internal Revenue Code of

1954. (R. 6-8, 18-20, 57.) The Tax Court entered decisions approving the Commissioner's determination. (R. 61-62.) Taxpayers have petitioned for a review of those decisions. (R. 63-66.)

SUMMARY OF ARGUMENT

1. Section 1244 was added to the Internal Revenue Code of 1954 in 1958 to encourage the financing of "small business corporations", by according ordinary (rather than capital) loss treatment to qualifying stock investments in such corporations if the venture turned out to be financially unsuccessful. However, to be entitled to the special benefits of that section, stockholders must strictly comply with the explicit definitional requirements of "section 1244 stock" laid down by Congress, including the requirement in Section 1244 (c)(1)(A) that the corporation must have "adopted a plan * * * to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan". (Emphasis added.) The Congressional Report explaining the enactment of Section 1244 states that "such plan must be in writing", and implementing Treasury Regulations (Section 1.1244(c)-1(c))--promulgated pursuant to the authority expressly delegated to the Commissioner (Section 1244(e))--also embody this requirement.

The Tax Court concluded that the Ranchers stock here in question was not offered and issued in the manner prescribed by Section 1244 (c)(1)(A), so as to be entitled to treatment as "section 1244 stock". Far from being clearly erroneous, as taxpayers contend, the Tax Court's conclusion is amply supported by the record. The minutes of the two resolutions relating to issuance of the stock, upon which

taxpayers rely as constituting a qualified "plan", did not specify an offering period of two years or less (or, for that matter, any period), as required by Section 1244(c)(1)(A), nor did the trust agreement referred to in the earlier resolution (and rescinded by the later one) specify the requisite period. Neither the external computations offered by taxpayers to indicate a probability that the stock would be issued within two years of adoption of the earlier resolution, nor proof that the stock was in fact issued within two years, suffices to meet the explicit statutory requirement that a period of two years or less must be "specified in the plan". To permit such extrinsic evidence to satisfy the statutory requirement would substitute the court's definition of "section 1244 stock" for the one carefully prescribed by the Congress.

2. In view of its holding that the stock did not meet the offering period requirement of Section 1244(c)(1)(A), the Tax Court deemed it unnecessary to reach and pass upon the Commissioner's alternative contentions that the stock also failed to meet other definitional requirements of Section 1244(c). If this Court agrees that Section 1244(c)(1)(A) was not satisfied, the Tax Court's decision is entitled to affirmance on that ground alone. But even if this Court should disagree, the decision below is nevertheless entitled to affirmance on any of the following alternative grounds:

(a) Neither the minutes nor the trust agreement specified the maximum amount to be received by the corporation for its shares, as required by the statute and the Regulations. This information is

necessary for a determination of whether the corporation qualifies as a "small business corporation". See Section 1244(c)(1)(B) and (2); Regulations Section 1.1244(c)-1(c).

(b) The stock was issued to taxpayers after a simultaneous offering was made to Sewmor (another corporation owned by taxpayers), in contravention of the provision in Section 1244(c) that Section 1244 stock "does not include stock if issued (pursuant to the plan referred to in subparagraph (A)) after a subsequent offering of stock has been made by the corporation". Under the implementing Treasury Regulations (Section 1.1244(c)-1(h)), this provision applies not only to stock issued after a "subsequent" offering, but also to stock issued after a "simultaneous" offering. See also Section 1244(c)(1)(C) and Regulations Section 1.1244(c)-1(h)(1).

(c) Some of the stock was not issued "for money or other property", as required by Section 1244(c)(1)(D), but was issued to one Savaria for services. See also Regulations Section 1.1244 (c)-1(f)(1).

ARGUMENT

THE TAX COURT CORRECTLY HELD THAT RANCHERS, INC., DID NOT ISSUE ITS STOCK IN THE MANNER PRESCRIBED BY SECTION 1244 OF THE INTERNAL REVENUE CODE OF 1954 AND THAT AS A RESULT TAXPAYERS, WHO WERE SHAREHOLDERS IN RANCHERS, WERE NOT ENTITLED TO THE ORDINARY LOSS DEDUCTION PERMITTED BY THAT SECTION

A. Introductory

A loss from the sale or worthlessness of stock (a capital asset) is a capital loss, the deductibility of which is limited to capital gains plus $1,000 of ordinary income. See Sections 165(g), 1211(b), 1221, 1222 of the Internal Revenue Code of 1954. However, Section

1244, Appendix, infra, carves out an exception to this general rule by permitting certain losses from the sale or worthlessness of "section 1244 stock," i.e., stock of a "small business corporation" as defined in subsection (c)(2), to be "treated" as ordinary losses if the stock constitutes "section 1244 stock" as defined in subsection (c)(1).

The question on this appeal is whether taxpayers qualified for "section 1244" losses on their stock in Ranchers, Inc., when that corporation was liquidated and taxpayers received only fractional returns on their initial investments. This in turn depends on whether Ranchers issued such stock in the manner prescribed by the explicit and detailed terms of the statute. The Tax Court, in a well-reasoned opinion, held that the stock was not issued under a plan which limited the duration of the offering to two years or less, as required by Section 1244(c)(1)(A), and, as its ultimate holding, determined that taxpayers were not entitled to the ordinary loss deduction permitted by Section 1244. (R. 59-60.) In addition to this major and fatal flaw in Ranchers' plan, other disqualifying defects in the plan and in the issuance of the stock itself lend added support to the Tax Court's decision. It is submitted, therefore, that on the basis of the record and the clear applicable legal standards, the decision of the Tax Court was correct and should be affirmed.

B. Failure to limit the duration of the stock offering

Section 1244(c) states the following requirement, among others, for issuance of "section 1244 stock":

(c) Section 1244 Stock Defined.--

(1) In general.--For purposes of this section, the term "section 1244 stock" means common stock in a domestic corporation if--

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan, (Emphasis added.)

* * * * *

Initially, it is questionable whether Section 1244 covers stock offerings which, as here, were not specifically and intentionally geared to meeting the requirements of that statute; it is a special relief provision which on its face places a premium on planning the issuance of stock so as to qualify under sharply-defined statutory terms. See Shapiro v. Commissioner, decided June 16, 1966 (P-H Memo T.C., par. 66,128); Franconi v. Commissioner, decided April 7, 1965 (P-H Memo T.C., par. 65,087); but see Bruce v. United States (S.D. Tex.), decided November 21, 1967 (68-1 U.S.T.C., par. 9112). But even assuming, arguendo, that a plan fulfilling all the requirements of Section 1244 would entitle taxpayers to the special ordinary loss treatment despite the fact that the stock was not originally issued with Section 1244 in mind, the failure to state a termination date of two years or less in the plan forecloses ordinary loss treatment for the stock; the absence of any one of the requirements prescribed by Section 1244(c)(1) disqualifies all of the stock issued under the plan from Section 1244 treatment. 2/ (R. 59.)

2/ Of course, taxpayers have the burden of proving that they come within the terms of Section 1244. Morgan v. Commissioner, 46 T.C. 878; Shapiro v. Commissioner, supra.

Ranchers' plan must be gleaned from two documents: the minutes of Ranchers' board of directors' meeting on January 5, 1962 (R. 32-35), and a trust agreement established between Ranchers and Sewmor pursuant to a resolution passed at that meeting (R. 36-44). In essence, the resolution and resulting trust established a plan whereby 3,000 shares of Ranchers would be purchased by the trust, which would be financed by a seven percent deduction from the salaries of Sewmor's employees with an equal amount contributed by Sewmor. The trustees would subsequently transfer the stock to the employees. 3/ However, at an annual meeting of Ranchers' shareholders on February 15, 1963, it was decided to discontinue the trust plan and issue the stock directly to Sewmor's employees. 4/ (R. 54-55.) The stock was fully subscribed and paid for by July 31, 1963. (R. 29, 56.) The resolution of the board of directors passed at the meeting held on January 5, 1962, states the following (R. 33):

> BE IT RESOLVED that 3,000 shares of stock of Ranchers, Inc., be, and the same is hereby, set aside and allowed for purchase by the trustees of the employees of Sewmor Sewing Center, Inc., pursuant to the trust agreement attached to these minutes, and that the corporation from said 3,000 shares sell stock of the corporation to the trustees at its book value but not less than the par value, to wit, $10.00 per share; that upon receipt from

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3/ It is interesting to note that if stock had been issued to the trust under this arrangement, taxpayers would not have qualified for ordinary loss treatment since they would not have continuously held the stock from the date of issuance. See Treasury Regulations, Section 1.1244(a)-1(b), Appendix, infra.

4/ Minutes can qualify as a "plan" under Section 1244(c)(1)(A) if they contain all of the required elements of a plan specified in that section of the Code and its interpretive Regulations. Rev. Rul. 66-67, 1966 Cum. Bull. 191. Although the resolution of February 15, 1963, modified the resolution of January 5, 1962, by rescinding the trust agreement, the taxpayers relied upon the trust provisions in contending that the requirements of Section 1244(c) were met, and the Tax Court likewise considered them for purposes of determining whether the requirements were met.

> the trustees of payment for said stock the same shall be issued to the trustees.

The pertinent portion of the trust agreement states that (R. 42):

> (f) When said allotted stock of Ranchers, Inc. to the amount of 3,000 shares has been purchased by the Trustees or on the _____ day of _____, 196__, whichever occurs earlier, this trust shall be terminated and all unused funds of each Second Party as shown by the account sheet of said Second Party shall be refunded to the Second Party entitled thereto and upon presentation of the trust and voting trust certificate of said Second Party to the Trustee, the stock represented by said trust and voting trust certificate shall thereupon be issued and delivered to said Second Party.

Clearly, neither of these documents provides for a termination date "ending not later than two years after the date such plan was adopted." Section 1244(c)(1)(A). See also Treasury Regulations, Section 1.1244 (c)-1(c), Appendix, infra.

Taxpayers argue (Br. 12, 23-24) that it was not intended that the plan would extend beyond a two-year period 5/ and that oral expressions of this intent made it unnecessary to reduce this portion of the plan to writing. Furthermore, they contend (Br. 25) that neither the statute nor its legislative history expresses the Congressional intent that the offer and the period specified must be in writing. Quite to the contrary, not only does the statute suggest a written plan by requiring a period "specified in the plan" (Section 1244(c)(1)(A)), but the legislative history clearly states that "such plan must be in writing." (H. Rep. No. 2198, 85th Cong.,

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5/ Taxpayer James A. Warner testified (R. 70) that the term of the trust was not to be extended over a two-year period. This appears to be incompatible with certain language in the employee's application for participation in the trust which permitted termination on his part only "after twenty-four (24) months by sixty (60) days written notice" (R. 37).

2d Sess., p. 8 (1959-2 Cum. Bull. 709, 714.) 6/ As the Tax Court pointed out (R. 59), Section 1244(a)(1)(A) requires both (1) that the plan must end not later than two years after the date on which the plan was adopted, and (2) that such period of two years or less must be specified in the plan. Although the offering by Ranchers ended within two years, to meet the first requirement 7/ (R. 60), the failure to state the period of the offering in the plan was fatal to its qualification for Section 1244 treatment. Eger v. Commissioner, decided August 30, 1966 (P-H Memo T.C., par. 66,128), pending on appeal (C.A. 2d); Morgan v. Commissioner, 46 T.C. 878; see Lichtenberg v. Commissioner, decided June 14, 1967 (P-H Memo T.C., par. 67,130); Spillers v. Commissioner, decided October 31, 1967 (P-H Memo T.C., par. 67,216); Bruce v. United States, supra. This requirement had to be met at the time the stock was offered. 8/ Spillers v. Commissioner, supra. The failure to establish the period for the stock offering in the plan is enough to deny taxpayers Section 1244 treatment. However, there are other flaws which also preclude taxpayers from obtaining ordinary loss treatment.

6/ Thus, Treasury Regulations, Section 1.1244(c)(1)(C), requiring that a plan be in writing, which taxpayers attack (Br. 26) as unreasonable, are consistent with legislative intent.

7/ Taxpayers' Specification of Error No. 6 (Br. 17) that the Tax Court erred in failing to hold that the offer was completed in less than two years overlooks a Tax Court observation to the contrary (R. 60). Specifications of Error Nos. 3, 4 and 5 (Br. 17; 30-31) deal with findings the Tax Court need not have made since the failure to state a two-year period in the plan alone is enough to disqualify stock from Section 1244 treatment.

8/ Computations presented by taxpayers (Br. 12-13; 23) to show that the seven percent deductions from the employees' salaries and matching company contributions would result in the purchase of all stock within

C. Failure to state the amount of the offering

Neither the minutes of the board of directors' meeting (R. 32-35) nor the trust agreement (R. 36-43) reflects the maximum amount to be received by the corporation for its shares, as required by the Regulations. Treasury Regulations Section 1.1244(c)-1(c), issued pursuant to a specific grant of authority delegated to the Commissione (Section 1244(e)), requires that "The plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued pursuant thereto." See also Section 1244 (c)(1)(B) and (2); H. Rep. No. 2198, 85th Cong., 2d Sess., p. 8 (1959-2 Cum. Bull. 709, 714). The resolution only states that the shares would be sold at "book value but not less than the par value, to wit, $10.00 per share." (R. 33.) There is thus no upper limit on the price to be paid for the shares and no maximum amount to be received by the corporation for their issuance, rendering the plan deficient on this count. See Eger v. Commissioner, supra; Spillers v. Commissioner, supra.

Strict compliance with the statutory definitions of "section 1244 stock" and "small business corporation" is essential to the operation of Section 1244. Given the Congressional objectives that no more than a specified amount may be invested to qualify for ordinary loss treatment, that the stock offering must be pursuant to a plan adopted after June 30, 1958, with a duration of not more than two years, and that the transaction must be an infusion of new capital and

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8/ (continued) about two years falls far short of the statutory requirement that the period be specified in the plan. Moreover, such estimates were based on past payrolls and payrolls could vary (including downward) in future years.

not a rearranging of old capital (Section 1244(c)(1) and (2)), one can readily see that there may be difficulty in separating shares which qualify from those which do not. A written and specific plan -- with its duration and aggregate amount spelled out -- satisfies the necessary identification requirements. 9/ Since these two requirements must be determined at the time the plan is adopted and the actual loss under the statute could occur many years later, only a written plan will preserve the record of compliance. 10/

D. Subsequent stock offering

Even if a corporation adopts a plan which qualifies under the statute, simultaneous or subsequent events may preclude the shares issued under the plan from receiving Section 1244 treatment. Therefore, assuming, arguendo, that Ranchers adopted a plan which fulfilled all of the requirements of Section 1244(c)(1)(A), a contemporaneous stock offering to Sewmor (R. 34), and a subsequent issue of stock to Robert Savaria for services (R. 55-56) before the shares in question were issued to taxpayers, disqualified their shares from Section 1244 treatment.

9/ The Tax Court has even held that minutes which specifically provided that common stock was to be issued "pursuant to the terms and provisions of Section 1244" did not qualify as a plan under Section 1244 because the critical element of the plan's duration was not revealed. Eger v. Commissioner, supra. Contrast this with the present situation where the plan's duration was also not included, there was no reference to Section 1244, and there seems to have been no intention to qualify under that section.

10/ For the same reason, the Regulations required that the issuing corporation must maintain records showing all stock issued pursuant to the plan. Treasury Regulations Section 1.1244(e)-1(a)(1) and (3), Appendix, infra; see also Morgan v. Commissioner, supra. Taxpayers did not introduce records into evidencee which satisfied these requirements.

The minutes of the January 5, 1962, meeting of Ranchers' board of directors contain not only the resolution to establish the trust for Sewmor's employees (R. 33), but also include a resolution which permits Sewmor to buy an unspecified amount of shares at book value but not below par, i.e., $10 (R. 34). Section 1244(c) states that "section 1244 stock" does not include stock if issued under an otherwise qualifying plan after a subsequent offering of stock has been made by the corporation. Treasury Regulations Section 1.1244(c)-1(h), Appendix, infra, states that even though the plan satisfies the requirements of Section 1244(c)(1), if another offering of stock is made by the corporation subsequent to or simultaneous with the adoption of the plan, stock issued pursuant to the plan after such offering shall not qualify as Section 1244 stock. See also H. Rep. No. 2198, 85th Cong., 2d Sess., p. 8 (1959-2 Cum. Bull. 709, 715). The offering under the plan and the offering to Sewmor were simultaneously made on January 5, 1962. 11/ (R. 32-35.) Taxpayers subscribed to and paid for their shares during the months of February through July, 1963. (R. 56.) The stock was fully subscribed by July 31, 1963. (R. 29.) Since the stock was issued to taxpayers after the offer to Sewmor, it was foreclosed from Section 1244 treatment.

11/ This is based on the assumption that the January 5, 1962, minutes and trust referred to therein, would be the controlling documents in determining whether a plan existed in this case. See fn. 4, supra. If the plan must be derived from the minutes of the meeting of February 15, 1963, then the stock offering to Sewmor is a prior offering which also eliminates the stock from Section 1244 treatment. Section 1244(c)(1)(C).

E. Issuance of stock for services

Section 1244(c)(1)(D) also requires, as a condition to qualifying as "Section 1244 stock", that the stock be issued "for money or other property." Stock issued for services rendered or to be rendered to the issuing corporation does not qualify as Section 1244 stock. Treasury Regulations Section 1.1244(c)-1(f)(1), Appendix, infra. See also H. Rep. No. 2198, 85th Cong., 2d Sess., p. 8 (1959-2 Cum. Bull. 709, 715). At a meeting on February 18, 1963, the board of directors of Ranchers decided to issue 100 shares of stock to Robert E. Savaria for his services performed in equipping the aircraft to be used in the corporation's fire retardant program. (R. 55-56.) The apparent issuance of this stock 12/ before the taxpayers fully subscribed for their stock (R. 29, 56) and, moreover in consideration for services rather than for "money or other property," disqualifies the taxpayer's stock from Section 1244 treatment on both counts.

In the final analysis, taxpayers' contention that stock received from Ranchers qualified as "section 1244 stock" disregards the explicit provisions of Section 1244 and the implementing Regulations and, if sustained, would render nugatory the express limitations upon the relief Congress intended to allow that section. 13/ Since Section 1244

12/ The stock is deemed issued when paid for, not when the certificates are delivered. Morgan v. Commissioner, supra; Lichtenberg v. Commissioner, supra. Since the stock here was being issued for services previously rendered, the date of issuance would be the date of the board resolution.

13/ It is elementary that exemption or remedial statutes are matters of legislative grace and must be strictly construed against the taxpayer. United States v. Stewart, 311 U.S. 60, 71; Cornell v. Coyne, 192 U.S. 418, 431-432; Better Business Bureau v. United States, 326 U.S. 279, 283; Helvering v. Ohio Leather Co., 317 U.S. 102, 106. "Nor can the doctrine that remedial legislation is entitled to liberal

is a tax relief measure, it cannot work against taxpayers; while compliance with its terms will afford the special relief, failure to meet them cannot lead the taxpayer to any unfortunate tax results. The track has been carefully laid by Congress and must be followed without deviation. There can be little doubt that Congress, by enacting such specific requirements, intended to place a premium on advance planning. As the Tax Court stated in Morgan v. Commissioner, supra, p. 889:

> Had the incorporators of and investors in Junction had good and timely legal advice, this confusion would probably have been avoided, but section 1244 being designed to provide a tax benefit to a rather limited group of taxpayers as it is, we feel that qualification for those benefits requires strict compliance with the requirements of the law and the regulations promulgated pursuant to the specific instructions therefor included in section 1244(e).

Neither the plan for the issuance of Ranchers' stock nor the stock issuance itself met the conditions of the statute and its implementing Regulations.

13/ (continued) construction, upon which the taxpayers also rely, be stretched to expand the reach of the statute of such evident limited purpose as this one." United States v. Zacks, 375 U.S. 59, 68. As the Second Circuit observed (per Learned Hand) in Smart v. Commissioner, 152 F. 2d 333, 335, certiorari denied, 327 U.S. 804, in dealing with a tax relief statute containing, as does Section 1244, specific conditions precedent to its applicability--

> On the other hand, the section is an exemption and as such must submit to close scrutiny; and -- what is more important -- Congress has been sparing in the relief given. * * *
>
> From all this it appears that we have to deal with a statute which not only has been amended, but amended with a precision which, it seems to us, should forbid any assumption that it is infused with a broad purpose, which we should ramify as the occasion may demand.

CONCLUSION

For the reasons stated above, the decisions of the Tax Court should be affirmed.

Respectfully submitted,

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FEBRUARY, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of _____, 1968.

_____
Howard J. Feldman, Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 1244 [as added by Sec. 202(b), Small Business Tax Revision Act of 1958, P.L. 85-866, 72 Stat. 1606, 1676]. LOSSES ON SMALL BUSINESS STOCK.

(a) General Rule.--In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as a loss from the sale or exchange of an asset which is not a capital asset.

(b) Maximum Amount for Any Taxable Year.--For any taxable year the aggregate amount treated by the taxpayer by reason of this section as a loss from the sale or exchange of an asset which is not a capital asset shall not exceed--

(1) $25,000, or

(2) $50,000, in the case of a husband and wife filing a joint return for such year under section 6013.

(c) Section 1244 Stock Defined.--

(1) In general.--For purposes of this section, the term "section 1244 stock" means common stock in a domestic corporation if--

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan,

(B) at the time such plan was adopted, such corporation was a small business corporation,

(C) at the time such plan was adopted, no portion of a prior offering was outstanding,

(D) such stock was issued by such corporation, pursuant to such plan, for money or other property (other than stock and securities), and

(E) such corporation, during the period of its 5 most recent taxable years ending before the

date the loss on such stock is sustained (or if such corporation has not been in existence for 5 taxable years ending before such date, during the period of its taxable years ending before such date, or if such corporation has not been in existence for one taxable year ending before such date, during the period such corporation has been in existence before such date), derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this subparagraph only to the extent of gains therefrom); except that this subparagraph shall not apply with respect to any corporation if, for the period referred to, the amount of the deductions allowed by this chapter (other than by sections 172, 242, 243, 244, and 245) exceed the amount of gross income.

Such term does not include stock if issued (pursuant to the plan referred to in subparagraph (A)) after a subsequent offering of stock has been made by the corporation.

(2) Small business corporation defined.--For purposes of this section, a corporation shall be treated as a small business corporation if at the time of the adoption of the plan--

(A) the sum of--

(i) the aggregate amount which may be offered under the plan, plus

(ii) the aggregate amount of money and other property (taken into account in an amount, as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time) received by the corporation after June 30, 1958, for stock, as a contribution to capital, and as paid-in surplus,

does not exceed $500,000; and

(B) the sum of--

(i) the aggregate amount which may be offered under the plan, plus

(ii) the equity capital of the corporation (determined on the date of the adoption of the plan),

does not exceed $1,000,000.

For purposes of subparagraph (B), the equity capital of a corporation is the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders).

(d) Special Rules.--

(1) Limitations on amount of ordinary loss.--

(A) Contributions of property having basis in excess of value.--If--

(i) section 1244 stock was issued in exchange for property,

(ii) the basis of such stock in the hands of the taxpayer is determined by reference to the basis in his hands of such property, and

(iii) the adjusted basis (for determining loss) of such property immediately before the exchange exceeded its fair market value at such time,

then in computing the amount of the loss on such stock for purposes of this section the basis of such stock shall be reduced by an amount equal to the excess described in clause (iii).

(B) Increases in basis.--In computing the amount of the loss on stock for purposes of this section, any increase in the basis of such stock (through contributions to the capital of the corporation, or otherwise) shall be treated as allocable to stock which is not section 1244 stock.

(2) Recapitalizations, changes in name, etc.--To the extent provided in regulations prescribed by the Secretary or his delegate, common stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets the requirements of subsection (c)(1) (other than subparagraph (E) thereof), or which is received in a reorganization described in section 368(a)(1)(F) in exchange for stock which meets such requirements, shall be treated as meeting such requirements. For purposes of paragraphs (1)(E) and (2)(A) of subsection (c), a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor.

(3) Relationship to net operating loss deduction.--For purposes of section 172 (relating to the net operating loss deduction), any amount of loss treated by reason of this section as a loss from the sale or exchange of an asset which is not a capital asset shall be treated as attributable to a trade or business of the taxpayer.

(4) Individual defined.--For purposes of this section, the term "individual" does not include a trust or estate.

(e) Regulations.--The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.

(26 U.S.C. 1964 ed., Sec. 1244.)

Treasury Regulations on Income Tax (1954 Code):

§1.1244(a)-1 Loss on small business stock treated as ordinary loss.

(a) In general. Subject to certain conditions and limitations, section 1244 provides that a loss on the sale or exchange (including a transaction treated as a sale or exchange, such as worthlessness) of "section 1244 stock" which would otherwise be treated as a loss from the sale or exchange of a capital asset shall be treated as a loss from the sale or exchange of an asset which is not a capital asset (referred to in this section and §§1.1244(b)-1 to 1.1244(e)-1, inclusive, as an "ordinary loss"). Such a loss shall be allowed as a deduction from gross income in arriving at adjusted gross

income. The requirements that must be satisfied in order that stock may be considered section 1244 stock are described in §§1.1244(c)-1 and 1.1244(c)-2. These requirements relate to the stock itself and the corporation issuing such stock. In addition, the taxpayer who claims an ordinary loss deduction pursuant to section 1244 must satisfy the requirements of paragraph (b) of this section.

(b) Taxpayers entitled to ordinary loss. The allowance of an ordinary loss deduction for a loss on section 1244 stock is permitted only to the following two classes of taxpayers:

(1) An individual sustaining the loss to whom such stock was issued by a small business corporation, or

(2) An individual who is a partner in a partnership at the time the partnership acquired such stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership.

In order to claim a deduction under section 1244 the individual, or the partnership, sustaining the loss, must have continuously held the stock from the date of issuance. A corporation, trust, or estate is not entitled to ordinary loss treatment under section 1244 regardless of how the stock was acquired. An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss under section 1244 with respect to such stock. Thus, ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership. Stock acquired through an investment banking firm, or other person, participating in the sale of an issue may qualify for ordinary loss treatment only if the stock is not first issued to such firm or person. Thus, for example, if the firm acts as a selling agent for the issuing corporation the stock may qualify. On the other hand, stock purchased by an investment firm and subsequently resold does not qualify as section 1244 stock in the hands of the person acquiring the stock from the firm.

* * * * *

(26 C.F.R., Sec. 1.1244(a)-1.)

§1.1244(c)-1 Section 1244 stock defined.

(a) In general. In order that stock may qualify as section 1244 stock the requirements described in paragraphs (b) through (h) of this section must be satisfied. Except for the requirement in paragraph (g) of this section, the

determination as to whether such requirements are met may be made at or before the time the stock is issued. The determination as to whether the requirement set forth in paragraph (g) of this section, relating to gross receipts of the corporation, has been satisfied may be made only at the time a loss is sustained on the stock. Therefore, at the time of issuance it cannot be said with certainty that the stock would qualify for the benefits of section 1244.

(b) Common stock. Only common stock, either voting or nonvoting, in a domestic corporation may qualify as section 1244 stock. For purposes of section 1244, neither securities of the corporation convertible into common stock nor common stock convertible into other securities of the corporation shall be treated as common stock. For definition of domestic corporation see section 7701(a)(4) and the regulations thereunder.

(c) Written plan. (1) The common stock must be issued pursuant to a written plan adopted by the corporation after June 30, 1958, to offer only such stock during a period specified in the plan ending not later than two years after the date the plan is adopted. The two-year requirement referred to in the preceding sentence will be met if the period specified in the plan is based upon the date when, under the rules or regulations of a Government agency relating to the issuance of the stock, the stock may lawfully be sold, and it is clear that such period will end, and in fact it does end, within two years after the plan is adopted. The plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued pursuant thereto. See §1.1244(c)-2 for the limitation on the amount that may be received by the corporation under the plan. For purposes of section 1244, an increase in the basis of outstanding stock as a result of a contribution to capital is not an issuance of stock.

(2) To qualify, the stock must be issued during the period of the offer, which period must end not later than two years after the date the plan is adopted. Stock which is subscribed for during the period of the plan but not issued during such period cannot qualify as section 1244 stock. Stock issued on the exercise of a stock right, stock warrant, or stock option (which right, warrant, or option was not outstanding at the time the plan was adopted) will be treated as issued pursuant to a plan only if the right, warrant, or option is applicable solely to unissued stock offered under the plan and is exercised during the period of the plan.

(3) Stock subscribed for prior to the adoption of the plan, including stock subscribed for prior to the date the corporation comes into existence, may be considered issued pursuant to a plan adopted by the corporation if the stock is not in fact issued prior to the adoption of such plan.

(4) Stock issued for a payment which, alone or together with prior payments, exceeds the maximum amount that may be received under the plan, is not considered issued pursuant to the plan, and none of such stock can qualify as section 1244 stock. See example (2) in §1.1244(c)-2(d).

* * * * *

(e) Prior offering. Stock will not qualify as section 1244 stock if at the time of the adoption of the plan under which it is issued there remains unissued any portion of a prior offering of stock. Thus, if any portion of an outstanding offering of common or preferred stock is unissued at the time of the adoption of the plan, stock issued under the plan will not qualify as section 1244 stock. An offer is outstanding unless and until it is withdrawn by affirmative action prior to the time the plan is adopted. Stock rights, stock warrants, stock options, or securities convertible into stock, which are outstanding at the time the plan is adopted, are deemed to be prior offerings. The authorization in the corporate charter to issue stock different from stock offered under the plan or in excess of stock offered under the plan is not of itself a prior offering.

(f) Issued for money or other property. (1) The stock must be issued to the taxpayer for money or other property transferred by the taxpayer to the corporation. However, stock issued in exchange for stock or securities, including stock or securities of the issuing corporation, cannot qualify as section 1244 stock, except as provided in §1.1244(d)-3, relating to certain cases where stock is issued in exchange for section 1244 stock. Stock issued for services rendered or to be rendered to, or for the benefit of, the issuing corporation does not qualify as section 1244 stock. Stock issued in consideration for cancellation of indebtedness of the corporation shall be considered issued in exchange for money or other property unless such indebtedness is evidenced by a security, or arises out of the performance of personal services.

* * * * *

(h) Subsequent offering. (1) Even though the plan satisfies the requirements of paragraph (c) of this section, if another offering of stock is made by the corporation subsequent to, or simultaneous with, the adoption of the plan, stock issued pursuant to the plan after such other offering shall not qualify as section 1244 stock. The issuance of stock options, stock rights, or stock warrants, at any time during the period of the plan, which are exercisable with respect to stock other than stock offered under the plan, shall be considered a subsequent offering. Likewise, the issuance of stock other than that offered under the plan shall be considered a subsequent offering. Since stock issued upon exercise of a conversion privilege is stock issued for a security, and stock issued pursuant to a stock option granted in whole or in part for services is not issued for money or other property, the issuance of securities with a conversion privilege and the issuance of such a stock option are subsequent offerings, because the conversion privilege and the stock option are exercisable with respect to stock other than that which may properly be offered under the plan. Stock issued under the plan before a subsequent offering is not disqualified by reason of such subsequest offering. The rule of this paragraph, together with the rule of paragraph (e) of this section, relating to offers prior to the adoption of the plan, limits section 1244 stock to stock issued by the corporation during a period when any stock issued by it must have been issued pursuant to the plan.

(2) Any modification of a plan that changes the offering to include preferred stock, or that increases the amount of stock that may be issued thereunder to such an extent that the requirements of section 1244(c)(1)(B) would not have been satisfied if determined with reference to such amount as of the date such plan was initially adopted, or that extends the period of time during which stock may be issued thereunder to more than two years from the date such plan was initially adopted, shall be considered a subsequent offering, and no stock issued thereafter may qualify. However, a corporation may withdraw a plan and adopt a new plan to issue stock. To determine whether stock issued pursuant to such new plan may qualify, section 1244(c) must be applied with respect to the new plan as of the date of its adoption. For example, amounts received for stock under the prior plan must be taken into account in determining whether the requirements of section 1244(c)(2), relating to definition of small

business corporation, are satisfied. In applying the requirements of section 1244(c)(2)(B), reference should be made to equity capital as of the date the new plan is adopted. The same principles apply if the period of the initial plan expires and the corporation adopts a new plan.

(26 C.F.R., Sec. 1.1244(c)-1.)

§1.1244(c)-2 Small business corporation defined.

* * * * *

(b) Amount received by corporation for stock. (1) At the time of the adoption of the plan the sum of the aggregate dollar amount to be paid for stock which may be offered under the plan plus the aggregate amount of money and other property which has been received by the corporation after June 30, 1958, for its stock, as a contribution to capital by its shareholders, and as paid-in surplus must not exceed $500,000. In making these determinations (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) such aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liabilities which were assumed by the corporation at such time.

(2) For purposes of the $500,000 test referred to in subparagraph (1) of this paragraph, the total amount of money and other property received for stock, as a contribution to capital, and as paid-in surplus shall not be reduced by distributions to shareholders, even though such distributions are capital distributions. Thus, once the total of such amount received after June 30, 1958, reaches $500,000, the corporation is precluded from subsequently adopting a plan under which section 1244 stock may be issued.

* * * * *

(26 C.F.R., Sec. 1.1244(c)-2.)

§1.1244(e)-1 Records to be kept and information to be filed with the return.

(a) By the corporation. The plan to issue stock which qualifies under section 1244 must appear upon the records of the corporation. In addition, in order to substantiate an ordinary loss deduction claimed by its shareholders, the corporation should maintain records showing the following:

(1) The persons to whom stock was issued pursuant to the plan, the date of issuance to each, and a description of the amount and type of consideration received from each;

(2) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of such property when received by the corporation;

(3) Which certificates represent stock issued pursuant to the plan;

(4) The amount of money and the basis in the hands of the corporation of other property received after June 30, 1958, and before the adoption of the plan for its stock, as a contribution to capital, and as paid-in surplus;

(5) The equity capital of the corporation on the date of adoption of the plan; and

(6) Information relating to any tax-free stock dividend made with respect to stock issued pursuant to the plan and any reorganization in which stock is transferred by the corporation in exchange for stock issued pursuant to the plan.

* * * * *

(26 C.F.R., Sec. 1.1244(e)-1.)